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THE SECURITIES ACTIVITIES OF COMMERCIAL BANKS

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In contrast to commercial banking, which primarily borrows and relends other people's money, investment banking primarily assists other people in raising their own funds. Commercial banks (and other depository institutions) are intermediaries that borrow money from savers in the form of deposits and relend them to ultimate borrowers by making loans or buying securities. Investment banks are intermediaries that assist borrowers in raising funds directly from savers by 1) advising in the design and origination of the securities to be sold, 2) underwriting the securities by buying them from the borrowers, and 3) distributing the securities by reselling them to investors. Thus, investment bankers deal in the securities originated by the issuer and, except for a brief period while they may be in inventory, do not own the securities. They are not investors. In contrast, commercial banks are investors buying and holding the securities originated by others. They finance these holdings by effectively transforming the original securities of the borrower into securities (deposits) on themselves that have different characteristics in terms of maturity, denomination, risk, and so on and selling them to different investors. Investment bankers also provide liquidity for securities issued by others by making a secondary market in them and buying the securities back from investors who wish to sell them before maturity and re-selling them to other investors or helping sellers locate buyers.

Besides the basic differences in their operational techniques, commercial and investment banking have traditionally differed in the maturity of the funds raised. Commercial banks have focused primarily on borrowing and lending short-term; investment banks have focused

primarily on helping borrowers satisfy their longer-term needs for financial capital. Because of these broad differences, commercial and investment banking tended to develop separately. But because they both dealt with the same raw material--money, they also provided some overlapping services. The extent of overlap has differed from country to country and even from time to time depending on the economic and political circumstances.

In the United States, commercial and investment banking have for the most part been conducted by different institutions, at times voluntarily and at other times by statute. Most recently, the Banking Act of 1933, which is popularly referred to as the Glass-Steagall Act, separated the two functions to a significant degree, following a period in which they had been effectively integrated. The separation of commercial and investment banking is in the British tradition. In other countries, such as Germany and France, the two types of banking are frequently conducted by the same institution.[1] In recent years, commercial and investment banks in the United States have increasingly provided the same or similar services, and the differences between the two types of institutions have narrowed. This process has been largely the result of dramatic advances in the technology of collecting, transferring, and manipulating information and funds that have made it easier to bypass legal and regulatory barriers, and changes in the economic environment that have both altered and increased the public's need for financial services.

However, established commercial and investment banks each have secured positions in markets in which they had been sheltered by law or

by regulation from competition from the other. As may be expected, some of these institutions have been reluctant to surrender these privileges peacefully, and have resisted the efforts of the other to penetrate their markets through changes in laws or regulations. Indeed, the battle for turf between commercial and investment banks is being hotly contested in national and state legislatures and regulatory agencies, as well as in the marketplace.

This paper traces the development of commercial and investment banking in the United States; discusses the domestic investment banking or securities activities in which commercial banks do engage (as of January 1984)--other than for the bank's own investment (portfolio) or the securities issued by the bank or its affiliates; examines the issues underlying the arguments for and against the separation of traditional commercial and investment banking; and considers future developments in the area.

Overview

Commercial banks have engaged in some securities activities (investment banking) virtually throughout their history. The particular type of activity has changed through time depending upon federal and state legislatures, the courts, and the chartering agency of the particular bank; the aggressiveness and innovativeness of the bank's management; available technology; and the prevailing economic environment. The securities activities in which commercial banks currently engage have expanded greatly in recent years and are likely to expand further in the future. This reflects a number of factors.

The demand for all financial services, including securities services, has increased. Greater economic wealth has increased the financial resources of households and business firms; longer life expectancies have increased both the magnitude and complexity of financial needs; higher rates of inflation have increased the importance of financial management; higher rates of interest have increased the cost of holding funds in noninterest bearing accounts; and more volatile interest rates have increased both the complexity and the risks of financial management. At the same time, the costs of providing these services have decreased. Advances in computer technology have permitted funds and information to be collected, transmitted, stored and manipulated cheaply and quickly. Indeed, as a result, almost anyone with a large computer can play and provide similar services.[2]

For many years, statutes and regulations have restricted the kinds of activities in which different classes of institutions may engage and the prices and interest rates that they may pay or charge for their services. The restrictions had been imposed to deal with the problems of an earlier age, primarily the massive bank failures during the depression years of the 1930s. They promoted safety by discouraging competition. Many of the regulations restricted (or were perceived to restrict) the ability of commercial banks to provide a number of financial services. As a result, through time, other financial institutions (existing or entirely new) stepped in to fill the void. Their job was made easier by the evolution of new communications and computer technology that increasingly eased circumventing the intent of the legal and regulatory barriers. Investment banking and other firms

not only were able to offer many new products, but were also able to offer products closely resembling traditional banking products--such as deposit-type securities (shares in money market fund) and general use consumer credit cards. In time, the commercial banks fought back by lobbying to have the laws changed, by challenging the restrictive regulations with the regulatory agencies and in the courts, and, perhaps most importantly, by increasing their own aggressiveness and innovativeness.

Commercial banks, particularly larger banks, are well positioned to expand their securities activities. They possess a large customer base for financial services, a large staff of trained personnel, and computer systems programmed for financial services. These provide the potential for significant economies of scope by adding activities that are closely enough related to their current activities to enable building on the existing facilities. In addition, some banks engage in a full range of investment banking overseas, where U.S. statutes permit equal treatment with local banks. Thus, they also have experience in providing such services. Although there is little evidence of excess profits or insufficient competition in those securities activities that appear to have been prohibited for banks, it is likely that the market for some of these services would be enlarged by bank entry and that, at least, some banks would succeed in attracting market shares away from nonbank competitors. Thus, commercial banks view additional securities activities both as generating potentially high revenues on little additional outlays and as rounding out the package of financial services they could offer customers to attract more of their overall

financial business. It should be noted, however, that any net savings from taking advantage of any economies of scale or scope may not accrue to the bank if at the same time that the banks expanded into the new activities nonbanks expand into banking activities previously prohibited them. Nevertheless, for the reasons reviewed above, banks have increasingly expanded into a number of areas previously believed to be insufficiently profitable or prohibited.

The statutory and regulatory restrictions on domestic securities activities by commercial banks appear not to be as carefully spelled out as many believed only a few years ago. As recently as the mid-1970's, students of banking were reasonably certain about which securities activities commercial banks could or could not conduct. But the events of recent years have badly shaken this perception. Activities perceived barely permissible 10 years earlier are common practice today, and some perceived nonpermissable are being introduced by more aggressive institutions. In addition, some of today's securities did not exist (e.g., money market funds), were not widely used (e.g., financial futures), or were not of sufficient importance (e.g., municipal revenue bonds), to be clearly covered in extant legislation or regulation. As a result, the permissibility (or lack thereof) of many of the activities has been determined on a case-by-case basis, either by a bank application to engage in the new activity or by a challenge to a bank's involvement in a particular activity. The determination of the legality of many of the services was eventually (or is now being tested) in the courts, most involving

lengthy appeals and, not infrequently, final review by the Supreme Court of the United States.

Moreover, hardly any particular banking legislation or regulation concerning securities activities or regulation applies equally to all commercial banks. Most frequently, one statute or regulation applies to national banks and one or more others will apply to state chartered banks, depending upon whether they are insured by the Federal Deposit Insurance Corporation (FDIC), members of the Federal Reserve System, and/or in which of the 50 states they are chartered. Indeed, the FDIC has ruled that some of the provisions of the Glass-Steagall Act do not apply to insured banks that are not members of the Federal Reserve. Nevertheless, the activities of these banks remain subject to the laws and regulations of the states in which they are chartered, which also spell out permissible security activities. Even when regulations apply equally to large groups of banks, it is unlikely that all banks will be affected equally. Securities activities are primarily engaged in by the larger banks. Smaller banks tend to offer a more limited number of these services. In addition, although thrift institutions are rapidly becoming more similar to commercial banks, they remain subject to different statutes and regulation.

History

Unlike commercial banks, investment banks need not obtain special charters. Until recently, most investment banks were not even incorporated. Even today, many investment banking houses are organized as partnerships. Because they were not incorporated and therefore were

not subject to the regulations that apply to corporations, the early investment banks could engage in any activity they wished and have offices in any location. Owing to the nature of their business, investment banking houses developed almost exclusively in major financial centers. Many offered deposit banking as well as underwriting services, although their investment banking activities of raising long-term funds for business firms and governments tended to dominate their commercial banking activities.

The early investment banks were generally organized by people who had made private fortunes as brokers or foreign-exchange dealers, or in nonfinancial lines of business and found that they could put these funds to profitable although risky use by underwriting and distributing new security offerings.[3] Outstanding financial securities had been traded for commissions in New York City since 1793. (The New York Stock Exchange was established for this purpose in 1817.) But new securities were sold directly to investors by the issuing firm itself. As the needs of firms and governments for new capital increased, direct sales to investors became increasingly less efficient and the need for specialists developed.

Many of the larger early investment houses in the United States were branches or affiliates of large banks in Europe, particularly in Great Britain, that had considerable underwriting experience and could distribute U. S. securities to their customers in Europe and provide the U. S. affiliate with new European securities. The golden era of investment banking was the period immediately after the Civil War, when the great banking houses of J.P. Morgan, Lehman Brothers, Kuhn Loeb,

and Goldman Sachs were established. These houses helped raise the capital, both in the United States and abroad, that financed the rapid industrialization of the country in the period between the Civil War and World War I.

The earliest commercial banks in the United States were chartered exclusively to accept fixed-value deposits and make primarily short-term, basically self-liquidating business loans, e.g., inventory loans repaid as the inventory was sold. This was in accordance with the "real bills" doctrine of banking that was popular at the time and justified money creation only if collateralized by short-term, self-liquidating real assets. Through the years, however, states began to permit their state-chartered banks to make longer-term loans and to enter into various aspects of investment banking, although they were not permitted to own common stock for their own accounts. At the same time, trust companies to manage the funds of wealthy individuals in a fiduciary capacity were organized in many states under general incorporation laws that gave them broader powers than commercial banks. In the process, they became involved in the trading of existing securities for their customers and then in underwriting new securities. In time, many trust companies requested and were granted deposit powers. By the beginning of the twentieth century, many trust companies were indistinguishable in their operations from both state-chartered commercial banks and investment banks.

In the meantime, the National Bank Act of 1864 granted the newly created national-chartered banks "incidental powers as shall be necessary to carry on the business of banking." This was initially

interpreted by both the Comptroller of the Currency and the courts as prohibiting most aspects of investment banking other than investing in government securities. However, competitive pressures from state banks soon forced increasingly broader interpretations. National banks were permitted to underwrite and trade securities, although initially they were restricted to issues of the federal government and municipalities in which they were permitted to invest for their own portfolios. Over time, to permit them to remain competitive with state banks, this authority was extended first to corporate bonds and then to corporate equities. National banks were also permitted to organize security affiliates under state charters. Unlike their parent commercial banks, however, these affiliates could have branch offices in any state and engage in full-service investment banking.

In 1927, the McFadden Act was enacted to equalize competitive conditions between national and state banks. National banks were permitted to branch in the states in which they were headquartered on approximately the same basis as state-chartered banks and to underwrite and trade directly almost all types of securities. By 1930, commercial and investment banking were almost fully integrated. Commercial banks played an increasingly important role in the securities markets. In 1930, commercial banks, trust companies, and bank affiliates underwrote an estimated 60 percent of all new bond issues, up from 37 percent only three years earlier.

The Banking Act of 1933

For reasons to be discussed later, the Banking Act of 1933 (Glass-Steagall Act) effectively separated commercial and investment

banking.[4] The Act:

1. Prohibited, with certain exceptions, commercial banks that are members of the Federal Reserve System from underwriting, distribution and dealing as principals in stocks, bonds, or other securities. The exceptions were federal government bonds, municipal bonds collateralized by the full faith and credit--i.e., taxing power--of the issuer (general-obligation or G.O. bonds), and deposit-type securities such as CDs.

2. Limited purchases of securities for a commercial bank's own account to debt securities approved by the bank regulatory agencies.

3. Prohibited commercial banks that are members of the Federal Reserve System from affiliating with investment banking firms, and

4. Prohibited firms and individuals engaged in investment banking from simultaneously engaging in commercial banking,[5]

Banks were given the choice of being one or the other, but not both. Almost all primarily commercial banks chose to remain commercial banks, and almost all primarily investment banks chose to remain investment banks. They divested themselves of the prohibited activities. The National City Bank (the predecessor of today's Citibank), the Chase National Bank (the predecessor of The Chase Manhattan Bank), and the Harris Trust and Savings Bank of Chicago dissolved their securities affiliate. The First National Bank of Boston spun off as a separate entity its affiliate, the First Boston Corporation, which has remained a major investment banking firm.

Lehman Brothers Kuhn Loeb is an example of an investment bank that discontinued its deposit business. J.P. Morgan and Company is an example of the few investment banks that chose to retain its deposit business and discontinue its securities activities. Some senior

officers left however, to establish the investment banking firm of Morgan Stanley. J.P. Morgan reorganized as the Morgan Bank, first as a private deposit bank and then incorporated as a state-chartered commercial bank. Today it is the Morgan Guaranty Trust Company.

Reasons for The Banking Act

The Glass-Steagall Act was a product of its time- the Great Depression, widespread bank failures, and severe loss of public confidence in the stability of the economic and political system. Its purpose was threefold:

1. To restore confidence in the commercial banking system by separating commercial from investment banking. Many investment banks experienced severe financial difficulties at the onset of the depression. The attempts by some banks to come to the aid of their troubled securities affiliates were widely viewed as weakening their already precarious capital positions. There was a widespread belief that the securities activities of the banks increased their susceptibility to financial strains and had contributed significantly to their financial troubles. (This occurred before the introduction of FDIC insurance, and depositors probably had good cause to be anxious about the ability of their banks to meet deposit demands at full par value.)

2. To prevent a channeling of funds from "legitimate" commercial uses to "speculative" uses. Such channeling was considered easier if commercial banks could engage in securities activities and were able to advise their deposit customers to purchase securities. Increased credit flows into the securities markets were believed to have increased the instability of the financial system and to have contributed greatly to the cumulative nature, and thus the severity, of the 1929 stock market crash. Many bank customers had bought stock on credit, provided by the bank, and when the market price of the shares declined below the value of the associated loan, the banks were forced to sell the stocks. These forced sales exerted further downward pressure on stock prices.

3. To eliminate the conflicts of interest and self-dealing that may be inherent in the marriage of commercial and investment banking. A number of such abuses had received national publicity in congressional hearings and, coming at a time of massive bank failures, had created a public outcry for strong and immediate remedial action. (The alleged abuses are described later in this paper.)

Current Securities Activities of Commercial Banks

A listing of many of the securities activities presently offered by commercial banks and the year in which they were introduced appears in Table 1. Some of these activities are discussed below.

Underwriting and Distributing U.S. Government Securities

Commercial banks have traditionally helped to underwrite (purchase from the issuer) and distribute (resell to investors) the new securities issued by the U. S. Treasury. Over time, these powers were extended to securities issued by federal and official international agencies, including the Federal Home Loan Bank Board and its affiliates, the Farm Credit System and its affiliates, the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), the Student Loan Marketing Association, and the World Bank (IBRD). A complete list of eligible federal and international agencies is shown in Table 2.

All Treasury securities are publicly sold at competitive auctions by the Treasury Department to the highest bidders in amounts up to the total amount of the particular issue for sale. Banks bid for Treasury securities both for their own investment accounts and for redistribution to other investors at a higher price. Generally, the largest banks bid to resell to other investors, including other banks, and act as security dealers. Individual commercial banks bid for these securities in competition with nonbank security dealers, other financial institutions, and investors in general. Like other bidders, commercial banks may submit competitive or noncompetitive bids for the new securities. In competitive bids, the securities are generally

awarded to the highest bidders in order of their ranking from highest price down until the Treasury has sold its desired amount. Bidders may generally submit as many different bids as they wish. Because successful bids are awarded at the price bid, all winners do not pay the same price. Although high bidders may win many securities, they may not be able to resell them at a profit as investors may go to other winning bidders, who paid a lower price, or purchase substitute securities on the secondary market. Banks may also submit noncompetitive bids up to a limited dollar amount in which they offer to buy the securities at the average price. Noncompetitive tenders are filled in full. But because of the small permissible amounts, noncompetitive bids are used only by small banks.

Because the Treasury designs its own securities, banks act only as underwriters and distributors; they do not participate in origination, although some representatives of commercial banks may serve on a standing committee that advises the Treasury in its debt management.

The issuance of securities by federal agencies differs from that by the Treasury. Similar to most issuers, other than the U.S. Treasury, federal agencies select one or more commercial banks or other security dealers to serve as financial advisors or fiscal agents and assist in determining their credit needs, in originating the security with respect to amount, maturity and coupon characteristics, collateral requirements, and any special option features such as call, put, or convertibility options, and in preparing the documentation about the issue that is provided potential investors. In addition, the advisor analyzes market developments and interest rates movements and

recommends the best timing for the sale. Unlike Treasury issues, most federal agency issues are sold by negotiation rather than by competitive bid. Some are also underwritten on a "best effort" basis in which the underwriter does not buy the entire amount of the issue but promises only to make a best effort to sell as many of the new securities as possible at the agreed upon price within a specified period of time.

Trading in U.S. Government Securities

Commercial banks are important makers of secondary markets for securities of the U.S. Treasury and federal agencies. They may act both as dealers buying as principals for their own account and selling from their inventory and as brokers buying and selling as agents for the accounts of others. As dealers, they generate revenues by selling the securities at a higher price than the price at which they were purchased; as brokers, banks collect commissions from either or both the seller and buyer. Because interest rates may move unfavorably while securities are held in inventory, dealers tend to assume greater risk than brokers.

Only the very largest commercial banks make active markets in Treasury securities. Of the 36 dealers that made sufficiently broad and continuous markets to be required to report their activities to the Federal Reserve Bank of New York in 1983, 13 were commercial banks. They are:

- Bank of America NT & SA (San Francisco)
- Bankers Trust Company (New York City)
- Chase Manhattan (New York City)
- Chemical Bank (New York City)
- Citibank, N.A. (New York City)
- Continental Illinois National Bank and Trust Co. (Chicago)

- Crocker National Bank (San Francisco)
- First Interstate Bank of California (Los Angeles)
- First National Bank of Chicago
- Harris Trust and Savings Bank (Chicago)
- Manufacturers Hanover Trust Company (New York City)
- Morgan Guaranty Trust Company (New York City)
- The Northern Trust Company (Chicago)

In 1982, these banks accounted for about 30 percent of all recorded dealer transactions. Treasury securities are by far the most actively traded security on the secondary markets. Most dealers will make markets for all Treasury securities, although markets tend to be more active for shorter-term issues.

Banks also make secondary markets in the securities of federal agencies. However, many banks tend to specialize, making more active markets for some securities than others. In particular, the banks tend to make markets for the securities of the agencies that they serve as financial advisors or underwriters.

Bank Dealer Operations Dealers generate profits in two ways; 1) from their trading and 2) from increases in the value of their inventories. Their trading profits are derived from selling securities at a higher price (lower interest rates) than the price at which they bought the securities. The difference between the selling (asked) and buying (bid) price at any moment of time is termed the spread. Dealers hold inventories of securities--termed positions--for the same reason any merchant holds inventory--to have stock on the shelf when a customer comes to buy--and their inventory strategy is basically the same as for other merchants. The amount and composition of inventory a dealer holds depends on:

1. the estimated volume of sales in each issue or maturity grouping,
2. the cost of financing,
3. expected interest rate changes, and
4. shape of the yield curve.

The larger are predicted sales in the next period of a particular security or all securities, the larger will be the inventory held in that or all securities. Dealers can sell securities they do not have by quickly purchasing the security elsewhere or by selling short and borrowing the security until it is purchased, but these strategies involve greater risks and costs.

The securities held in inventory must be financed. Banks typically provide funds for their trading departments at a price. The price varies from bank to bank, but is generally at or close to the daily federal funds rate. While held in inventory, securities yield a return to the bank. The difference between the market return on a security and the cost of financing paid by the bank or the trading department is referred to as the carry. The carry may be either positive or negative depending on the shape of the yield curve (term structure of interest rates). If the yield curve is upward sloping, so that yields on longer maturity bonds are higher than on shorter maturity bonds, the carry on most Treasury securities tends to be positive and to become bigger with increases in maturity. If the yield curve is downward sloping, the carry on some of the securities will be negative and become more negative the longer the maturity.

The decision as to how much inventory to hold is also dependent on the direction and magnitude of expected movements of interest rates. If rates are expected to decline (so that bond prices are expected to rise), dealers will build up their positions relative to expected trading volume. Conversely, if rates are expected to increase, dealers will run down inventories. Because changes in rates affect the prices of longer-term securities more than short-term securities, interest rate expectations will also affect the maturity composition of inventories.

Lastly, some dealers will take into account the shape of the yield curve. If the yield curve is upward sloping, they will buy longer-term securities, hold them as their maturities become shorter and their yields lower, and then sell them before maturity at the lower yield. This strategy is referred to as riding the yield curve. The profit potential from this strategy is greater the more steeply upward sloping the yield curve and the closer the maturities of the securities are to the point on the yield curve at which the slope changes the most.

In sum, dealers will hold greater overall inventories:

1. the greater are expected sales,
2. the lower is the cost of financing and the more positive is the carry,
3. the more interest rates are expected to decline, and
4. the more positively sloped is the yield curve.

These factors will also affect the maturity composition of the inventory. The last two factors tend to entail more risk than the first two. If interest rates move contrary to expectations or the yield curve shifts unfavorably so it becomes less positively sloped or

even negatively sloped, dealers may experience losses on their inventories. In recent years, dealers have made increasing use of the futures market to hedge their positions and to reduce their exposure to interest rate risk.

Underwriting and Distributing Municipal Securities

National banks have been permitted to underwrite and distribute debt issues of state and local governments collateralized directly or indirectly by the full faith and credit of the issuer (general obligation- or G.O.--bonds) since the early 1900's and state-chartered banks in most states even longer. Banks are permitted to underwrite only a limited number of municipal revenue bonds.

Unlike many other types of securities activities, commercial banks of all sizes underwrite some municipal bonds, particularly the new issues of the government units in which the banks are located. Most general obligation bonds are sold by the issuer to the underwriter by competitive bid, although some are sold by negotiation in which the underwriter is selected by the issuer before the sale. Most revenue bonds are sold by negotiation. In competitive bids, the issuer awards all the bonds to the lowest bidder. The profit to the underwriter comes from selling the bonds to investors at higher prices. In negotiated sales, the price paid to the issuer by the underwriter and frequently also the underwriter spread, or difference between the underwriter's purchase price and intended reoffering price, are prearranged through negotiation, although the issue price reflects expected market conditions.

New municipal bond issues are typically sold to underwriters in serial form. A serial issue is a package of bonds containing individual bonds having different maturities. Serial issues may contain bonds with as few as two different maturities or as many as 50. The package is sold to an underwriter as a unit at one price. The underwriter unbundles the package and reoffers each maturity individually to investors at its estimated market price. The underwriter may experience a profit smaller than expected or even a loss if the prices at which the individual maturities are sold are less than those expected at the time the bid was tendered. The bonds are generally resold before their issue date so that inventories need not be financed.

Frequently, the dollar size of a new issue is too large for any one underwriter to handle singly, both in terms of the risk of not being able to resell the bonds at the expected prices (thus not realizing the target spread) and in terms of the ability to market the bonds to investors. For such issues, individual underwriting firms join together in temporary syndicates to bid or negotiate for particular issues. The syndicates frequently include both commercial banks and investment banks. The size of the syndicate may vary from two firms for small issues to over 50 firms for very large issues of nationally recognized issuers.

The ability to distribute the issue successfully depends in part on the familiarity of the investors with the issuer. Thus, small issuers appeal primarily to local investors and progressively larger issuers to progressively more distant investors. The largest issues have national

markets. Individual underwriting firms join different syndicates for different issues, although they typically remain in the same syndicate for all issues of the same issuer. Within the syndicate, the bidding and pricing strategies as well as any origination assistance to the issuer are provided by one or more firms that also took the lead in organizing the syndicate. These firms are referred to as managers, and their names appear first and in bold print on any advertisements of the sale, known as tombstones. Managers are reimbursed extra from the syndicate for their services. The other syndicate members share in any profits proportionately both to the underwriting liability they assume and to the amount of bonds they sell.

Commercial banks as a whole underwrite about 50 percent of the total dollar volume of G.O. municipal bonds, although the percentage appears to have been declining in recent years. Some analysts attribute the bank's declining share of the G.O. market to their inability to deal in municipal revenue bonds and thus to be in a position to offer customers a full line of tax-exempt securities.

Banks are permitted to underwrite and distribute only those municipal revenue bonds--bonds collateralized solely by the revenues derived from the capital project financed by the bonds--that are issued for housing, dormitory or university purposes. Commercial banks had been prohibited from underwriting and distributing any revenue bonds by the Glass-Steagall Act. Until then, national banks had been permitted to underwrite and distribute all municipal revenue bonds since about 1900 and most state-chartered banks even longer. But, in those days, revenue bonds accounted for a very small proportion of total new

municipal bonds issued. In the 1930s, the dollar amount of revenue bonds accounted for only an estimated 10 percent of total new municipal issues. Since 1960, however, revenue bonds have accounted for progressively larger percentages of total new municipal issues. By 1982, these bonds accounted for three-quarters of the total dollar volume, spurred by an increasing reluctance by taxpayers to authorize generalize obligation bonds financed by general taxes, the increasing use of user costs to finance projects, and the increasing tendency of local governments to enter into services previously provided by the private sector and amenable to similar types of financing.

The Housing and Urban Development Act of 1968 permitted commercial banks to underwrite and distribute municipal revenue bonds issued for housing, dormitory, and university purposes. In 1982, these accounted for almost 50 percent of the dollar volume of all new municipal revenue issues, although they have accounted for considerably smaller percentages in other years.

Trading Futures Contracts.

Banks may trade futures contracts for securities and precious metals which they are permitted to trade on the cash or spot markets. They may also furnish customers with advice in connection with these transactions. Futures contracts are contracts for the delivery of a security or asset at a particular date in the future at a fixed price determined today. Because payment for a contract typically occurs concurrent with delivery, payment is also deferred. Futures trading occurs on organized futures exchanges according to the rules and regulations of the exchange. (Contracting for future delivery may also

be made directly between two parties according to their own negotiated rules on the forward market. These contracts are referred to as forward contracts. Banks have long operated in a number of forward markets, notably foreign currencies.) Futures contracts may be traded for the bank's own account and for customers. Bank trading is permitted in futures contracts for gold, foreign currencies, Treasury securities, certificates of deposit, and other contracts on futures exchanges for securities in which banks are permitted to trade on the spot market. Banks typically become members of futures exchanges and trade directly, although they could conduct such transactions through other dealers as brokers. The trading entity must be approved by and registered with the Commodity Futures Trading Commission as a Futures Commission Merchant (FCM) and be subject to its regulation. The trading personnel must be registered representatives.

Banks have been permitted to trade futures contracts for customers only since 1982. In that year, the Board of Governors of the Federal Reserve permitted J. P. Morgan & Company, the parent holding company of the Morgan Guaranty Trust Company, to organize a futures trading affiliate and the Comptroller of the Currency authorized the North Carolina National Bank to establish a futures trading subsidiary of the bank. The Commodity Futures Trading Commission gave approval to these units to begin trading shortly thereafter. Since then, FCM's have been organized by other banks, and in 1983 the Fed approved futures commission merchants as a generally permissible activity for bank holding companies under Regulation Y.

Trust Investments

Commercial banks may provide trust services either as part of the bank or as a subsidiary of itself or its parent holding company. Trust customers encompass a wide range including individuals, pension programs of business firms, nonprofit organizations, and labor unions, endowment funds, such as universities and hospitals, and so on. At year-end 1982, 4,041 commercial banks operated trust departments and managed assets totalling $689 billion.

As a fiduciary, the bank may purchase and sell any type of security at the request of the customer or, with the approval of the customer, at its own discretion. At first, banks managed each trust account separately. But over time, it became evident that significant cost savings were possible, particularly for smaller trusts, if the accounts were pooled for investment purposes and managed as larger common funds with the same investment objectives. Commingling of trust accounts for such purposes has been permitted as long as the commingling is not used to solicit accounts for primarily investment purposes rather than for the fiduciary services generally associated with a trust account. That is, banks may pool trust accounts as long as the service is sold to customers primarily as a fiduciary trust service and not as an investment service. The later activity was defined first by the Board of Governors of the Federal Reserve System and then, over the objection of the Comptroller of the Currency, by the Supreme Court of the United States to represent the sale of securities in mutual funds, which is prohibited by the Glass-Steagall Act.[6] (The question of bank selling of mutual funds is addressed later in this paper.)

In a recent ruling, the Comptroller permitted Citibank to invest funds in separate Individual Retirement Accounts (IRAs) collectively in common trust funds managed by the bank. Because of the retirement and pension characteristic of IRAs, Citibank and the Comptroller consider the management of these accounts as primarily fiduciary services rather than investment services and thus permissible within the Supreme Court's interpretation of the Glass-Steagall Act.[7] This interpretation has been challenged in the courts by the Investment Company Institute, the trade association for investment companies and mutual funds. Citibank offers three accounts--an equity fund, an income fund, and a money market fund. These funds are registered with the Securities and Exchange Commission. Since then, a number of other national banks have filed registration statements to offer similar accounts. The FDIC has proposed permitting banks under its primary jurisdiction to offer money-market type mutual funds.[8]

Dealing in Commercial Paper

Commercial paper is unsecured short-term promissory notes issued by large business firms. Initial maturities are less than nine months, generally from one to three months, in order to be exempt from registration with the Securities and Exchange Commission. Although commercial banks are major investors in commercial paper, they apparently did not underwrite or distribute such paper on the primary market nor trade in it on the secondary market in significant volume until 1978. In that year, the Bankers Trust Company (New York) began to deal in commercial paper of third parties. The appropriateness of this activity was challenged as a violation of the Glass-Steagall Act

by the nonbank securities industry. The basis for the challenge was reviewed by the Board of Governors of the Federal Reserve System, as the regulator of state member banks. The Board reaffirmed its position that third party sales of commercial paper was permissible within the Glass-Steagall Act.[9] A. G. Becker, a large investment banking firm, then brought suit against the Board of Governors.

A district court upheld Becker's challenge. The court ruled that commercial paper was a security as defined in the Glass-Steagall Act and not a bank loan as deemed by the Board of Governors and thereby nonpermissable. The Board of Governors appealed this decision, and in 1982 the Court of Appeals reversed the lower court's decision. It ruled that commercial paper closely resembled a bank business loan and was not a security under Glass-Steagall. The Appeals Court noted, however, that its ruling applied only to large denomination commercial paper sold to large, informed investors and that it might not be equally applicable to smaller denomination paper sold to the general public. In response, the Board of Governors promulgated specific regulations covering commercial banks dealing in commercial paper.[10] (It should be noted that neither CD's nor bankers' acceptances are considered securities under Glass-Steagall and that commercial banks have traditionally traded bankers' acceptances, which are one of the oldest financial instruments, and have traded third party CD's almost since their inception in the early 1960's.) The Supreme Court has agreed to review the decision of the Appeals Court.

Private Placements

Private placements represent the sale of a new securities issue directly by the issuer to one or a small group of large investors.

This process is often cheaper than the more usual public underwriting, since it bypasses some or all of the middleman, does not require SEC registration, and can be completed quickly. Registration is waived because large investors are presumed to be sufficiently knowledgeable and informed about the issue, from both their own investigations as well as their negotiations with the issuer and to be aware of the risks involved. Security issuers often use the services of an intermediary to help originate the security, locate promising investors, and negotiate financing terms. Larger banks have increasingly offered this service at a fee. However, a 1977 survey found that only some 30 large banks offered private placement services,and the dollar amount of such placements by these banks accounted for less than 10 percent of total private placements.[11] Both the Board of Governors and the Comptroller of the Currency have ruled this activity permissible within Glass-Steagall. (The Comptroller had ruled earlier that private placements for which the bank was compensated on a best effort or contingency basis were not to be permissible for national banks.)

Sponsoring Closed-End Investment Funds

Closed-end investment companies sell shares to investors and use the funds raised to purchase investment securities for their own portfolios. The shares of investment companies are generally less risky for investors than those of the individual firms in which the fund invests because the fund can reduce risk both through diversification by pooling the funds and through professional management. Closed-end funds issue shares when they are first organized and, at times, issue additional shares thereafter. The market values of

the shares are related to the average market value of the shares in the fund's investment portfolio. After initial issue, a fund's shares may be traded by individual investors on the secondary market, but the fund may not repurchase its own shares until liquidation. Thus closed-end funds differ from open-end (or mutual) funds, which stand ready to repurchase their outstanding shares at any time at their net asset value and also to issue additional shares at any time at this price upon demand. Because of the limited issuance of these funds, the courts have ruled that closed-end funds are not principally engaged in the issuance or public sale of securities and are not an activity that is prohibited to commercial banks by Section 20 of the Glass-Steagall Act. In 1972, the Board of Governors of the Federal Reserve System authorized nonbank affiliates of bank holding companies to sponsor closed-end funds subject to its Regulation Y.[12] In 1981, the courts upheld this interpretation.[13]

Investment Advising

Commercial banks themselves and their holding company affiliates may offer economic, financial and investment advice and counseling to a wide range of clients including open-end (mutual) investment companies, closed-end investment companies (including those sponsored by the bank), mortgage or real estate trusts, households, business firms, and state and local governments. Such services may include assisting issuers of securities in designing and marketing new issues (short of actually underwriting and distributing some of them), making economic forecasts, and providing portfolio investment and budgeting assistance. Banks charge fees for such services. Recently, some banks

have proposed cooperative undertakings with mutual fund sponsors to create and market "private label" mutual funds to bank customers. The bank would provide the fund with the initial contact with the customer and investment advice. The mutual fund would sell and repurchase the securities. The partners would share in the commissions.

Mergers and Acquisitions

Banks have always been permitted to advise client firms on mergers and acquisitions. This service includes searching for partner firms that have the characteristics desired by a client, recommending on the advisability of a particular merger or acquisition, developing a financial strategy for the merger or acquisition, serving as an intermediary between merging partners, and advising on how to prevent a merger or acquisition with an unwanted suitor. Banks are in a favorable position to furnish such advice because they already have close contacts with a large base of business customers to whom they provide credit and other services. Large, international banks also appear favorably positioned to assist in international acquisitions, particularly in those countries in which they have a presence.

The fee for advising on successful mergers and acquisitions or on merger repelling is based on the value of the assets involved. A typical fee schedule is referred to as the "Lehman Formula," used by the investment banking firm of Lehman Brothers Kuhn Loeb. It entails 5 percent of the first $1 million of assets involved, 4 percent of the next $1 million, 3 percent of the third million, 2 percent of the fourth million, and 1 percent of the remainder.[14]

Brokerage Activities

The role of commercial banks in providing brokerage services is one of the more controversial and rapidly changing areas. Until the enactment of the Glass-Steagall Act, security trading as an agent (broker) and a principal were generally treated alike. But Glass-Steagall distinguished between the two. Section 16 of the Act states that for national banks:

> The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order and for the account of customers, and in no case for its own account, and the association shall not underwrite any issue of securities and stock.

There are a number of provisions permitting dealing in debt securities backed by the full faith and credit of the federal, state and local governments and in some municipal revenue bonds. As noted in footnote 5, these restrictions are made applicable to banks that are members of the Federal Reserve System through another section of the Act. Bank powers to underwrite securities and to deal in securities as principals have been reviewed earlier. Unlike dealers, brokers do not buy and sell for their own account but receive commissions from trades between buyers and sellers arranged through their assistance. Brokerage is a pure agency relationship. Until recently, banks did not publicize their brokerage activities nor actively solicit such business. Most banks regarded it as a convenience and accommodation service provided to good customers. Indeed, a ruling by the Comptroller of the Currency in 1936 stated that these services had to be provided at cost without profit and that the customer must already have had a non-securities activity relationship with the bank. In 1948, the Comptroller

liberalized the restriction against profits and it was removed altogether in 1957.[15]

In the early 1980s, commercial banks began to expand their brokerage services and to solicit business from the public. In 1981, BankAmerica Corporation applied to the Board of Governors to acquire the Charles Schwab Corporation and operate it as a nonbank affiliate. Schwab was the largest "discount" broker in the country. It traded securities at low commissions, extended margin credit, and provided custodial services. Schwab did not offer investment advice, its salespersons were paid a straight salary and did not receive commissions, and customers did not have a personal broker. Although headquartered in San Francisco, the firm had a number of branch offices throughout the country. Through the use of a free 800 telephone number and aggressive advertising and pricing, Schwab solicited customers nationwide.

Before the Fed could act on this application, Security Pacific National Bank (Los Angeles) announced a cooperative venture with the Fidelity Group, a large sponsor of mutual funds and a registered dealer-broker firm, in which Fidelity would execute and clear trades and maintain accounts for Security's customers on a contract basis. Shortly thereafter, the Security Pacific received permission from the Comptroller of the Currency first to establish a de novo subsidiary of the bank itself to provide brokerage services, then to purchase an established discount broker and operate it as an affiliate of the bank, and finally to form a subsidiary to provide "back office" brokerage support to other banks.[16] In January 1983, the Board of Governors

approved BankAmerica's application to purchase Schwab and, later in the year, added brokerage services as an activity permitted all bank holding companies under Regulation Y. (In January 1984, the U.S. Supreme Court agreed to review an appellate decision that upheld the Board's approval.)

Brokerage services can also be offered by the bank itself without establishing a subsidiary. Although such an arrangement restricts the service to bank locations, it avoids the need to register as a broker with the Securities and Exchange Commission. The Securities Exchange Act of 1934 requires that all security brokers and dealers register with the Commission, but exempts commercial banks. Brokerage subsidiaries of the bank or of the holding company are not exempt. Registration involves compliance with SEC regulations for the protection of investors and oversight of operations and practices by both the Commission and designated self-regulatory organizations of the national security exchanges on which the broker-dealer trades and the National Association of Security Dealers (NASD). The regulations and oversight focus on the process of advertising for and soliciting customers; the truthfulness of promotional materials and reports; the disclosure of relevant information concerning both the broker-dealer and the securities traded; the character, supervision, and competency of employees, including the establishment of qualification requirements evidenced by training, experience and examination and the power to revoke registration and suspend violaters from securities participation; recordkeeping requirements; examination, inspection and internal controls; the adequacy of execution and confirmation of

orders; minimum bonding requirements; and customer protection against insolvency, including minimum capital requirements. Although exempt from direct SEC supervision, bank brokerages activities are supervised by the bank regulatory agency having primary jurisdiction and are subject to similar regulations. In November 1983, the Securities and Exchange Commission proposed that because bank brokerage services have changed greatly since the exemption was initially granted and now actively solicit public business, they should now be required to register with it and be subject to its jurisdiction even if the activity is one conducted jointly with an already registered broker-dealer.[17]

Banks have moved quickly into the active brokerage business in all four basic forms--through the bank itself, through an affiliate of the bank, through an affiliate of the bank holding company, or jointly with an established broker-dealer firm. In early 1984, some 2,000 banks were providing active brokerage services, mostly through a cooperative arrangement with a nonbank broker-dealer.

Precisely what kinds of brokerage services may be provided by national and state-chartered Federal Reserve member banks is unclear, particularly since the approvals of these services through affiliates until mid-1983 were on a case-by-case basis rather than by general regulation. Almost all bank brokerage services charge commission fees that are below those charged by full service brokers for comparable transactions and are similar to those of non-bank discount brokers. While generally this reflects the fewer services bundled into the package sold, not all bank brokerage services or nonbank discount

brokers offer the same package. Some offer only trading services. Others add custodial services, a designated "personal" salesperson, margin credit, investment advice, 24-hour service, newsletters, portfolio analyses, insolvency insurance, and many more. As a result, their prices and "discounts" vary. As noted, Schwab traditionally has not offered advice or a personal broker, nor has it paid its brokers a volume-related commission. This appeared in BankAmerica's application and became the service approved by the Board of Governors. But these characteristics need not apply to all brokerage services approved. For example, Security Pacific's application to the Comptroller for a de novo security brokerage affiliate did not address the form of compensation to salespersons or whether customers would receive a personal salesperson. The Board of Governors did not use the word "Discount" in its order including brokerage services as a permissible activity for bank holding companies and has indicated that it is prepared to consider investment advice and other services. In late 1983, the Comptroller permitted a bank to establish a subsidiary to provide investment advice to its customers, including buy and sell advice on individual securities and an investment advisory letter.[18] The subsidiary will be registered under the Investment Advisers Act with the SEC. The bank already had a discount brokerage subsidiary. Although the two subsidiaries will be separate, their activities will be coordinated and security advice by the advisory service will be offered broker customers on a nonexclusive basis. The Securities Industry Association is challenging this ruling.

Banks that prefer to offer brokerage services in conjunction with a registered nonbank broker can do so in a number of ways.[19] Because discount brokerage services involve relatively large fixed costs and relatively small variable costs, the primary consideration in selecting an arrangement is expected sales volume. In low volume plans, the broker provides most of the services. The bank incurs little costs. It publicizes the service, opens new accounts, receives payment from customers for security sales as an agent for the broker, and may provide custodial services. The broker typically furnishes the bank customers with an 800 telephone number; answers inquiries; accepts orders; executes; clears, and confirms trades; finances margin credit; maintains customer records; and prepares and mails periodic statements. The bank receives a small percentage of the commissions generated by its customers' transactions. The commission fee schedule for the customer is determined by the brokerage firm.

In higher volume plans, the bank provides more of the services, incurs more of the costs, and keeps more of the revenues generated. The bank typically markets the service and provides all customer contact, including opening and maintaining accounts, answering inquiries, accepting orders, receiving and making payments, providing margin credit, providing custodial services, confirming trades and mailing periodic statements. The bank also determines the customer commission fee schedule. The broker basically executes and clears trades upon order of the bank, for which it is paid either a fixed fee per transaction or a percentage of the commissions. Because all customer contact is with the bank and the statements received have only

the bank's name, the broker is effectively an invisible partner. Alternative plans falling between these two extremes may be negotiated between the bank and the nonbank broker. A growing number of nonbank brokers are providing these services for commercial banks.

Banks that operate their own broker subsidiary generally do not own a seat on security exchanges and contract with a firm that does to execute the transactions and frequently also to clear the securities. Whether banks that offer brokerage services in conjunction with a registered broker-dealer will be required to register with the SEC if the SEC's proposed rules are adopted, is likely to depend on the extent of a bank's involvement in arranging the transactions and in storing the securities. The greater the involvement, the more likely the requirement to register.

As noted earlier, both the FDIC and the FHLBB have ruled that institutions under their direct regulatory jurisdiction are not subject to Glass-Steagall and thus may operate in a wide array of securities activities, including more complete broker-dealer operations. In 1982, the FDIC issued proposed rules covering permissible securities activities. Comments were received and the proposal modified in 1983 but it has not yet been issued in final form.[20] To date, no commercial bank has applied to the FDIC for these powers--in part because many banks conduct their new securities activities through holding company affiliates, which are subject to Federal Reserve jurisdiction and thus indirectly to the restrictions of Glass-Steagall, and in part because only smaller banks, that provide fewer securities activities, are under the sole jurisdiction of the FDIC, and their

activities must still conform to state laws that, on the whole, prohibit a wide range of securities activities. The FHLBB has approved a number of full service broker operations, including dealer activities, to affiliates of savings and loan association service corporations, which in turn are affiliates of S&L's or S&L holding companies and have broader authority than S&L's. The largest of these is INVEST, a separate full-service securities firm cooperatively owned through their service corporations by some 100 savings and loan associations. It has recently announced its intentions to solicit business from commercial banks that are not members of the Federal Reserve System.

Agency Investment Plans

Banks have traditionally offered on an agency basis a variety of security investment plans, generally through their trust departments. In Automatic Investment Services (AIS), a prearranged amount approved by the customer is deducted regularly (e.g., monthly) from a participating customer's account. The bank prepares a list of a limited number of large, well-known firms in which the bank is willing to make share purchases, but individual recommendations are not made. The customer selects the individual shares and amounts, and becomes the sole owner of the securities. The customer benefits from any lower brokerage fee the bank pays from purchasing the stocks in larger quantities. The bank profits from higher brokerage activity or shares in the brokerage commissions directed at other brokers.

Banks also offer dividend reinvestment plans. Basically, these plans provide for the automatic reinvestment of all or part of the

dividends received by customers in additional shares of the paying firms. The attraction of these plans is that customers may share in any commission cost savings the bank may experience through pooling funds and purchasing in larger quantities. In addition, some firms offer to sell shares purchased through dividend programs at discounts from current market value.

The oldest dividend reinvestment plans involve the establishment of a custodial account, placing customer's securities in the account, and ordering the bank to reinvest a designated percentage of the dividends of the paying corporation in additional shares of that firm. More recently, banks have established automatic reinvestment dividend plans with corporations for whom they provide other securities services, such as being the dividend paying agent or transfer agent. Shareholders in these firms, customers or not, can arrange to have all or part of the dividends on their holding of the particular firm to be sent to the bank for reinvestment in shares of these firms. In 1982, Congress exempted dividends paid by public utilities from federal income taxes up to $750 annually per taxpayer if reinvested in the shares of the paying utility. Banks provide this service for utility firms who are their customers. The bank again profits from increased brokerage activity, shares in the brokerage activity directed to other brokers, or may be paid a fee by the firms whose dividends are reinvested.

Security Swaps

The higher and more volatile rates of inflation in recent years have created higher and more volatile rates of interest. As a result, many lenders became increasingly reluctant to commit funds for long

periods of time at fixed rates of interest. For their part, many borrowers became reluctant to accept an interest rate that could increase during the term of the loan, i.e., variable or floating rate securities. Thus, frequently mismatches occur where lenders and borrowers find themselves with securities they do not prefer. Some financial intermediaries have found it profitable to seek out such "discontented" market participants and to assist them in swapping their securities for more suitable securities. As long as the intermediary bank does not buy or sell the securities for its own account but acts solely as an agent charging a commission, such assistance is a permissible activity for commercial banks.

Nonpermitted Securities Activities

Most commercial banks are not permitted to engage either directly or through holding company affiliates in securities activities currently considered to be banned by the Glass-Steagall Act, by the Bank Holding Company Act for not being "so closely related to banking or managing or controlling banks as to be a proper incident thereto," or by state provisions. The clearest prohibition is against stock in almost all activities but investment as a fiduciary or in sponsored closed-end funds and the purchase and sale as an agent on commission for customers. With only infrequent exception, commercial banks are prohibited from investing in corporate stock for their own account, from underwriting and distributing new stock issues, and from trading in stock as principals. Nor may they sell shares directly in mutual funds or pooled trust funds in which fiduciary services are not the major component.

Similar prohibitions apply to corporate debt, but banks are permitted to invest in investment grade corporate bonds and notes, including convertible bonds for their own portfolio and may underwrite, distribute, and deal as principals in bankers acceptances and large denomination commercial paper. Banks may also not underwrite, distribute, or trade in municipal revenue bonds except those issued for housing, dormitory, or university purposes.

Under Section 20 of the Glass-Steagall Act, Fed member banks also may not be affiliated with firms "engaged principally in the issue, flotation, underwriting, public sale or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities." Section 32 of the Act prohibits an officer, director, or employee of a firm "primarily engaged" in these activities to be an officer, director, or employee of a Fed member bank. But recent interpretations of these sections by the Comptroller of the Currency and the Federal Deposit Insurance Corporation over the objections of the Federal Reserve have permitted investment companies, such as Dreyfus, and mutual fund advisors and investment banking firms, such as J.W. Seligman, to acquire commercial banks. The two agencies have been assisted in implementing these rulings by a provision in the Bank Holding Company Act of 1970 that defines a commercial bank for purposes of Federal Reserve jurisdiction over bank holding company affiliates as a bank "which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans." To avoid Federal Reserve jurisdiction, the applicant banks proposed to discontinue either offering demand deposits

or making commercial loans. These banks are referred to as "nonbank banks."[21] In addition, the Comptroller has also ruled recently that income obtained by an investment firm from advising or managing mutual funds is not income from the sale of securities in determining whether these firms are primarily or principally engaged in the sale of securities. Because advising is the major activity and source of income for most investment firms and advisers do not control mutual funds, these firms may own national banks.[22] Investment banks and mutual funds affiliate with nonbank banks for a number of reasons, including access to federally insured time deposits (particularly MMDAs which are otherwise similar to money market funds), demand deposits, national payments clearing system, and wider trust powers.

The FDIC has ruled that the securities restrictions of the Glass-Steagall Act do not apply to insured state-chartered banks that are not members of the Federal Reserve and has proposed regulations that would permit these banks to underwrite top-rated corporate debt. It also proposes to permit these banks to underwrite all securities, including corporate equities and mutual funds, on a "best effort" basis in which the bank agrees to act only as an agent and does not buy any of the securities for its own account.[23]

Until mid-1983, the Federal Home Loan Bank Board had also approved the affiliation of both investment banking firms and investment companies with savings and loan associations on the basis that the Glass-Steagall Act does not apply to savings and loan associations. At that time, the Board adopted a moratorium on further applications for such combinations. At least until reviewed by the courts, these

actions cast further confusion on the permissible securities of commercial banks.

In addition, banks have moved aggressively to participate in cooperative ventures in which the apparently prohibited activity is undertaken by another, independent firm and the revenues are split. Thus, for example, some banks entered the retail brokerage business in this way when the legitimacy of this activity was still in doubt and maintained this arrangement afterwards as a matter of efficiency even when the legitimacy had been approved. More recently, banks have proposed similar arrangements with mutual fund sponsors. A bank provides its customer base and investment advice, the sponsor sells the "private label" mutual fund, and the two share in the revenues. The Comptroller has recently ruled that national banks may lease space on bank floors, including their public lobbies, on an arms-length basis to firms that engage in activities prohibited the bank and collect rental fees based on a percentage of the firm's gross revenues and income from that activity at that location. The leased space does not have to be separated from the bank's space by walls, although some indication of separate entities must be provided. The banks have argued that their failure to provide customers with full-service investment banking puts them at a competitive disadvantage with nonbank security dealers.

Arguments For and Against Commercial Bank Participation in Securities Activities

The arguments for and against liberalizing commercial bank activities in the securities markets can be grouped under four

headings: competition, economies of scale, bank stability, and conflicts of interest.[24]

Competition and Concentration

Those who favor increased commercial bank participation in securities activities argue that because investment banks have expanded into some traditional commercial bank areas, it is only fair to permit commercial banks to retaliate and invade some traditional investment bank areas. They say also that bank entry would increase the number of firms, thereby enhancing competition and improving the quality of service to seller (borrower) and buyer (investor) alike. This would be particularly true for the underwriting of municipal revenue bonds and of corporate securities issued by smaller, regional firms. Commercial banks are located in almost every community and take a close interest in the financial welfare of the community. Many smaller cities do not have offices of investment banking houses. And when they do, they are few in number and mostly likely are retail branches of firms headquartered elsewhere, frequently in other states. Commercial banks would provide alternative, local bidders. Larger banks would also provide better capitalized competition for more highly leveraged large investment bankers.

A number of studies have provided evidence that bank participation makes a difference in the prices paid on new issues.[25] As noted earlier, commercial banks may bid on new municipal G.O. bonds but not on many new municipal revenue bonds. These studies show that new G.O. bonds, on average, have received more bids and have sold at lower interest rates than did revenue bonds with the same credit rating.

They conclude that permitting banks to bid on new revenue issues would increase the number of bids and lower the interest yields, thereby providing significant cost savings to state and local governments. Similar savings would accrue to private corporations in the underwriting of their new securities and to individuals and institutions in the sale of newly issued securities on the primary market as well as outstanding securities on the secondary market.

Opponents of greater bank participation in the securities markets argue that commercial banks have an unfair advantage over investment banks. They have more intimate knowledge of the financial conditions of many firms and government units that they have acquired in the process of providing lending and deposit services to these customers; they have superior access to low cost funds through their deposit activities and the discount window at the Federal Reserve; and they have a ready, "captive" market for the securities they underwrite regardless of the price in their own portfolios, in those of their correspondent banks, and in those of their trust accounts. As a result, although bank entry may intensify competition in the short run; in the longer run it would lead to the failure and exit of many investment banks and result in a lower number of firms and reduced competition. As evidence of the importance of these advantages, the opponents point to the very rapid increase in the percentage of new securities underwritten by the commercial banks in the late 1920s, after national banks had been given approval to engage in these activities, and to their eventual domination of this market shortly before the enactment of the Glass-Steagall Act.

Opponents of giving commercial banks greater securities powers are not impressed by the studies claiming that interest rates would be lowered on municipal revenue bonds if commercial banks could bid on them. They claim that the researchers did not hold enough other things constant. General obligation bonds of a particular credit rating are not equivalent in default risk to revenue bonds of the same credit rating. The ratings are relative for each class of bonds. Generally, an Aa-rated revenue bond has a greater risk of default than an Aa-rated G.O. bond. Permitting banks to underwrite revenue bonds would not transform them magically into G.O. bonds of the same rating. As a result, the number of overall bids and interest rates would remain unchanged; commercial banks might simply take a share of the market from investment banks.

The opponents of greater powers for banks argue that because of the all-pervasive nature of money, concentration in the financial markets is widely considered to be even more undesirable than concentration in other markets. The commercial banking market is already highly concentrated. Less than 2 percent of the total number of banks hold full one-half of all bank deposits. Worse yet, 2 percent of all banks hold two-thirds of the dollar amount of assets held in bank trust accounts.[26] If commercial banks drive investment banks out of business, concentration in all financial services would be greatly increased. The evidence from countries in which commercial and investment banking are fully integrated suggests such higher degrees of concentration. In addition, in some countries, banks have acquired significantly greater political power as well as economic power.

Moreover, opponents say that bank entry may not even increase competition in the short run. Instead of entering the new lines of activity as separate entities (de novo), commercial banks may combine in ownership or in bidding (in the form of a temporary syndicate) with investment banks. As evidence of this, they note that the percentage of the dollar volume of new municipal G.O. bonds, on which both commercial and investment banks may bid, that is underwritten by the largest firms is only a little smaller than that for municipal revenue bonds, on which generally only investment banks may bid. Commercial banks frequently combine with investment banks in syndicates in submitting bids on G.O. bonds. On the other hand, it may be argued that if commercial banks were permanently permitted to bid on all municipal revenue bonds, they would be more willing to incur the heavy start-up costs required to have their own marketing and distribution system and more apt to increase the number of bidding syndicates.

Finally, opponents argue that commercial banks have other unfair advantages over investment banks. Deposits provide them with an artificially low cost of funds, both because they are insured by a federal government agency and because their costs were until recently in large part held down by Regulation Q. Investment banks, in contrast, must obtain many of their funds from the banks in the form of bank loans on which the banks may be expected to charge a markup over their own costs. In addition, commercial banks may deduct most interest costs for tax purposes regardless of whether they own tax-exempt municipal bonds in their portfolios, whereas investment

banks may not deduct interest on funds borrowed to purchase municipal securities.

Economies of Scale and Scope

Advocates of expanded commercial bank powers argue that corporate underwriting, brokerage, and complete money-management services are not significantly different from many of the financial services currently offered by commercial banks. Commercial banks already possess trained and qualified personnel and much of the capital equipment necessary for these activities. Adding the new services would result in lower average costs to consumers through economies of scale and scope. Moreover, the greater convenience that would be provided consumers by offering these services at some 55,000 commercial bank offices throughout the country would reduce their effective cost and increase the demand for these services further. Consumers would be able to satisfy all their financial needs at one place, and commercial banks could truly offer full-service banking.[27]

Opponents argue that significant economies and lower costs are unlikely to be realized. Personnel trained in lending activities or in underwriting government securities cannot be shifted readily to analyzing equities or underwriting corporate securities without considerable retraining. Investment banks are equipped to handle the total volume of underwriting and money management currently prohibited for commercial banks. Transfer of some of this business to commercial banks would leave investment banks with excess capacity. Any cost saving at commercial banks would be offset by higher costs at investment banks. To the extent that this makes investment banks less

effective competitors, commercial banks would not be forced to pass through to their customers any economies they might realize.

Bank Stability and Risk

Commercial banks tend to have higher capital-to-asset ratios than do investment banks. Proponents of wider commercial bank securities powers argue that bank entry would strengthen the degree of competition in the new areas without weakening the commercial banks. Indeed, investment banks may be encouraged to augment their capital positions in order to match the aggressiveness of the commercial banks. This would decrease the likelihood of failure and increase the stability of the financial sector overall.

Not so, argue the opponents. The securities business is far more risky than most commercial banking activities, as reflected both in the variability of earnings and in the number of failures. As a result, current levels of bank capital appropriate for their current activities would be inadequate and the possibilities of bank failure increased. Moreover, whether or not investment banking is in fact riskier, many depositors perceive it as such, through its close association with the stock market. If commercial banks enter investment banking, these depositors may lose confidence in their banks and withdraw some of their funds, FDIC insurance notwithstanding. Although this would be unlikely to lead to a crisis such as that in the 1930s, it would increase the degree of instability in the financial system and reduce the efficiency of the national payments system. Lastly, if a securities affiliate were to get into financial difficulties, it is argued that the commercial bank is likely to come to its rescue by

providing resources in order to maintain the bank's reputation. Proponents of this line of reasoning point to this experience in the early 1930's and more recently in the mid-1970's when many banks came to the rescue of affiliated, and even nonaffiliated but similarly named, real estate investment trusts (REITs). This produced a significant drain on the bank's capital, increasing its riskiness.

Conflict of Interest and Other Abuses

Opponents of permitting commercial banks increased power to participate in securities markets point to the abuses that were uncovered when the banks were permitted these activities before the Glass-Steagall Act. Congressional hearings at the time disclosed numerous instances of serious conflicts of interest and self-dealing. Many commercial banks were accused of having forced securities they had underwritten on their customers, their own trust departments, or their correspondent banks without regard to risk or the interests of the buyers.[28] Many of these buyers suffered losses later, during the depression. At times, the bank itself purchased the securities to prevent one of its own underwritings from being unsuccessful, thereby reducing the credit quality of the bank's own investment portfolio.

Some commercial banks were found to have paid large additional salaries and bonuses to their officers who were also officers of the banks' securities affiliates in the 1920's. One bank set aside 20 percent of its annual net earnings for this purpose. These payments, which were viewed to be excessive, reduced the capital base of these banks and increased their vulnerability to the financial crisis that occurred a short time later.

Congress also focused on other potential conflicts inherent in conducting commercial and investment banking under the same roof. Many of the banks' transactions might not be independent or at "arm's length," determined solely by their economic merits. Firms that agreed to use the bank's underwriting facilities might be provided credit on more liberal terms than otherwise, and firms that used other underwriters might be denied credit. Customers might be provided more liberal credit on securities underwritten by the bank, particularly on those the banks had difficulty selling. Good loan customers of the banks might be given preferential treatment in the underwriting and marketing of their securities. The sale of new equity securities might be recommended to capital-deficient loan customers, and the proceeds used to repay the loans and protect the quality of the banks' loan portfolio.

Moreover, in the conduct of their business, commercial banks are apt to acquire information not available to others about a customer that is important in evaluating the customer's financial prospects. Thus, for example, a bank may obtain information on a loan customer that would affect its decision to underwrite or invest in the customer's securities, or on a customer whose securities it had underwritten, that would affect the bank's decision to extend credit to the firm. Such "inside" information may lead to both conflicts of interest between departments within the bank and a comparative advantage over firms that engage in only one of these activities.

Proponents of broader commercial bank securities powers concede that abuses did occur, but that legislation enacted since the 1930s has

greatly reduced the possibilities of a recurrence. Among the legislative actions, they cite the establishment of the Securities and Exchange Commission, numerous disclosure requirements and investor-protection provisions enacted by the Securities Act of 1933 and the Securities Exchange Act of 1934, the introduction of margin requirements on stock purchases,and the increased regulation of commercial banking affiliates by the Federal Reserve under the Bank Holding Company Act. In addition, bank regulatory agencies have been provided with additional powers to discover, halt, and penalize abusers. Bank examination practices have also been upgraded.

These proponents recognize that not all potentials for abuse can be eliminated from commercial banking any more than from any other industry. They argue that with proper protection, however, the public can obtain the benefits of greater bank participation in securities activities without suffering the abuses of the earlier era.

Effectiveness of Statutes and Regulations Limiting Securities Activities of Commercial Banks

How effective have the statutes and regulations been since 1933 in restricting the securities activities of commercial banks? The answer appears to be that it depends on the time and the place. As indicated earlier, banks have increased their activities in securities activities significantly in recent years, without major or even many minor changes in legislation. The interpretation of the existing statutes by the courts and, in particular, by the regulators has changed, however. Perhaps even more important, the attitude and aggressiveness of

commercial banks has also changed, intensifying and waning as economic conditions and competition have changed.

Until recently, banks, on the whole, had been cautious in re-entering the securities activities apparently forbidden them by the Glass-Steagall Act. When decisions had to be made by regulators, the Comptroller of the Currency has tended to interpret the regulations more broadly and the Federal Reserve more narrowly. The Comptroller has permitted banks effectively to offer limited mutual funds through pooled trust funds after the Board of Governors had ruled against such activity and before the ruling was overturned by the Supreme Court (Camp vs. The Investment Companies Institute (1971)) and to enter into limited combinations with mutual funds and security dealers over the objection of the Federal Reserve (Dreyfus National Bank and J.W. Seligman Trust Company, N.A., 1983). The FDIC has ruled that the restrictive securities provisions of Glass-Steagall do not apply to insured non-Fed member banks and has proposed rules for a broad range of securities activities of banks under its primary jurisdiction, including underwriting activities. In 1983, it approved insurance for state chartered banks purchased by Prudential-Bache Securities in Georgia and organized de novo in New Hampshire by the Fidelity Mutual Fund Group and in Delaware by E.F. Hutton. Merrill Lynch has received a state charter for a bank in New Jersey. These banks do not offer either deposits available on demand or business loans (including commercial paper and CDs of other banks) and are thereby not defined as banks ("nonbanks") by the Bank Holding Company Act for purposes of Federal Reserve supervision.

Even the Federal Reserve has occasionally provided broad interpretations that extended the banks' securities powers, such as on commercial paper and private placements. In many cases, however, the regulators did not act until forced to do so by the banks and then acted narrowly solely on the description of the activity provided by the applicant bank. Thus, the scope of the permissible activity has been delineated only a step at a time and still does not appear to be completely specified. A good illustration of this sequence of events is bank entry into the general brokerage business.

The limitation on bank involvement in broad retail brokerage activities appears to have been mainly self-imposed, at least since 1970. It is doubtful that either the Comptroller or the Federal Reserve would have evaluated an application by the Security Pacific or the BankAmerica Corporation much differently in 1972 than in 1982. True, before May 1975 minimum retail brokerage commissions were fixed by the New York Stock Exchange, which would have made it harder for banks to capture market share from full-service investment banking firms. Nevertheless, the banks did not lobby actively for the removal of this barrier. On the whole, banks did not find accommodation brokerage services very profitable. In 1976, the Chemical Bank in New York City began to offer broader brokerage services and advertised its availability.[29] However, the program did not appear to be as successful as expected and was terminated not long afterwards.

The current apparent prohibition against banks providing brokerage services also providing investment advice to the same customers also appears to be primarily self-imposed. Because Schwab did not provide

customers with investment advice before its proposed acquisition by BankAmerica, permission to offer such advice was not included in the BankAmerica-Schwab application to the Federal Reserve. It was also not included in Security Pacific's application to the Comptroller to begin security brokerage services de novo without comment. Advice is not mentioned explicitly in Glass-Steagall as an activity that is prohibited. The bank's activities in dealing in securities and stock "shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers." Does providing advice on particular stocks imply that the bank and not the customer is taking the initiative in placing the order and thus produce a violation of the above clause? Is giving investment advice on brokerage activities "so closely related to banking or managing or controlling banks" that the Board of Governors would not consider it an appropriate activity for affiliates of bank holding companies? The Fed has already permitted bank holding company affiliates to engage in a wide range of investment advising to an equally wide range of bank customers. As noted, in 1983, the Comptroller has permitted a national bank to have both a discount broker and an investment advisory affiliate. How significantly does this service differ from that of a full-service broker?

Similarly, the banks have complained that regulations did not permit them to offer a product competitive with Merrill Lynch's Cash Management Accounts (CMA) until the authorization for money market deposit accounts (MMDA's) in December 1982. CMAs usually combined five separate services--a consumer credit line, a credit card, security

trading, a sweep money market account and check writing--wrapped together by a single accounting statement. But commercial banks were always able to offer consumer credit lines and credit cards and to deal in federal and many municipal securities. As argued above, they also could have provided general retail brokerage services.

Before the authorization to offer money market deposit accounts MMDA's in December 1982, paying market rates of interest on deposits had been a more severe problem for the commercial banks when market interest rates climbed above Regulation Q ceilings. The sale of money market funds not subject to interest rate ceilings has been considered a sale of securities and therefore not permissible under the Glass-Steagall Act. It is clear, however, that the problem was due to Regulation Q, not to the Glass-Steagall Act, insofar as it prevented banks from offering small investors a deposit account paying market interest rates. Yet, until recently, however, few banks (other than the largest) actively lobbied for the repeal of Regulation Q. In addition, banks could have provided customers with repurchase agreements. Although these are not insured, neither are money market funds accounts. Lastly, as a few banks did shortly before the authorization for MMDA's, they could have joined with a money market funds in a cooperative agreement to offer "private label" funds to their customers in which the fund invests heavily in the banks' CD's.

Check writing facilities are not a problem, of course. Indeed, money market funds use commercial banks for this service. But check writing on deposits paying market rates was difficult for banks themselves. They could have offered such services through cooperative

ventures with money market funds, and it would have been technically possible for banks to tie check writing with repurchase agreements through some form of overdraft provision. Although the latter arrangements were likely to have encountered resistance from the Federal Reserve, they were not often tried. If they had been combined with earlier lobbying against Regulation Q, changes might have occurred before December 1982.

In sum, it would appear that the commercial banks' limited activities in providing securities and ancillary services is to a large extent the fault of the banks themselves. They were inhibited, for good or for bad reasons, as much by internal, self-imposed constraints and lack of imagination as by external constraints. At first, the lack of aggressiveness of the banks may have reflected the cautious attitude after the Depression and round of bank failures coupled with the unfavorable public attitude to bank involvement in securities activities that resulted in the enactment of Glass-Steagall. But in more recent years, it more likely reflected commercial bank involvement in other activities that they considered potentially more profitable to the neglect of securities activities.

The Future of Bank Securities Activities

As discussed earlier, some commercial banks, particularly larger banks, may enjoy potential economies of scope by engaging in securities activities. Nevertheless, throughout United States history charges of increased risk, undue concentration of power, and abusive conflicts of interest have resulted in banks being periodically stripped of some of

their securities powers. Over time, however, the banks have generally been successful in regaining some--if not all--the lost powers. Except for severely restricted purposes, at least, national banks in this country have not been permitted to own common stock for their own investment account. In 1933, the Glass-Steagall Act appeared to deprive them also of the powers to deal in almost all but government securities that are fully collateralized by the full faith and credit of the issuer. In recent years, these prohibitions have become less onerous. The boundaries to bank participation in securities activities, once perceived to be carefully circumscribed by law and regulation, began to be perceived as amorphous. What activities could and could not be undertaken began to be increasingly probed by more aggressive institutions willing to incur the substantial legal expenses necessary to fight the permissibility of the activity through the regulatory agencies, and, if challenged, the courts, and possibly even the Congress.

In 1968, Congress permitted commercial banks to deal in municipal revenue bonds issued for housing, dormitory, and university purposes. In the early 1970's, the Board of Governors permitted banks through their holding company affiliates to become advisors to both open and closed-end investment funds and to sponsor closed-end funds, and the Comptroller permitted national banks to provide automatic investment services. In the late 1970's, the Board permitted banks to continue to deal in commercial paper and to assist in private placements. In 1982, the Board and Comptroller both permitted banks to engage in general retail brokerage activities; the Comptroller permitted the sale of

commingled IRA investment accounts that closely resemble mutual funds; and the Board approved trading in financial futures. In addition, in areas in which the legitimacy of the activity was in doubt, bank have started to engage in cooperative arrangement with firms already operating in the area--e.g., security brokerage with established discount brokers and mutual funds with established mutual fund sponsors, and to share in the revenues.

As a result, many larger banks have increased their investment banking activities. A number of these banks have centralized all or most of there securities activities in investment banking or capital markets departments that are deliberately designed to resemble nonbank investment firms. These banks have also emphasized their international scope and their operation of full-service investment banking in a number of major foreign countries. This permits them to open the international capital markets to their clients through the sale of Eurodollar or foreign currency securities. In addition, smaller state chartered banks that are not members of the Federal Reserve System are being authorized wide securities powers by the FDIC, although they may still be restricted by state law, and the FHLBB has no general policy statement concerning the securities activities of its member associations, other than to note that they are not subject to the provisions of the Glass-Steagall Act.

The major setback in the banks' expansion into securities activities was the 1970 ruling by the Supreme Court that overturned the Comptrollers' approval of banks offering commingled trust funds as a retail investment vehicle. Even this may not be a lasting restriction

in light of the Comptroller's ruling on pooling IRA accounts and a willingness by banks to offer mutual funds in conjunction with nonbank fund sponsors.

At the same time, investment banking firms have been reasonably successful in offering commercial banking-type services. In the late 1970's, money market funds were ruled not to be deposits. In the early 1980's, investment banks were permitted to establish new commercial banks under limited circumstances. Thus, commercial and investment banks have begun to become more similar again, much as they had done in the 30 years before the enactment of Glass-Steagall. Legislation has been proposed in recent years, with the support of the Reagan Administration, to extend the reach of both commercial and investment banks into the other's turf. Except for relatively minor areas, however, these proposals have received little support and their chances for early enactment appear small. Too many powerful groups are asked to share their private turf in exchange for what they view to be inadequate compensation in terms of new turf. (By contrast, legislation has greatly expanded the commercial banking powers of thrift institutions, and regulatory initiatives have greatly expanded their investment banking powers.)

If enactment of major new banking legislation is unlikely, what is likely to occur is a continued nibbling away of the ability of Glass-Steagall to keep commercial banking and investment banking separate by both industries with the periodic assistance of one or more regulatory agencies. It would not be greatly farfetched to predict that Glass-Steagall will be no more effective in maintaining a separation between

commercial and investment banking in a few years than the McFadden Act and the Douglas Amendment to the Bank Holding Company Act have been in preventing interstate commercial banking. The new securities activities of commercial banks and new commercial banking activities of investment banks will, for the greater part, just be organized less efficiently than they would in the absence of the Act. Indeed, it would appear from most recent events that aggressive commercial banks or aggressive investment banks could offer almost as many "prohibited" activities as they wish as long as they are willing to incur the potentially large legal expenses involved. The major exceptions are likely to be full corporate security ownership and underwriting for commercial banks and full transactions deposit services for investment banks.

TABLE 1

COMMERCIAL BANK SECURITIES ACTIVITIES

Activity	Year Started
Underwriting and Distributing	
U.S. Treasury Securities	Always
U.S. Federal Agency Securities	Various years
Municipal Securities	
General Obligation	Early 1900's*
Some Revenue Bonds	1968
Trading	
U.S. Treasury Securities	Always
U.S. Federal Agency Securities	
Municipal Securities	
General Obligation	Early 1900's*
Some Revenue Bonds	1968
Financial and Precious Metal Futures	1983
Dealing in Commercial Paper	1978**
Private Placements	Always
Sponsor Closed-End Funds	1974
Offshore Dealing in Eurodollar Securities	Always
Mergers and Acquisitions	Always
Trust Investments	
Individual Accounts	Always
IRA Commingled Accounts	1982
Automatic Investment Service	1974
Dividend Investment Service	Always
Financial Advising	
Closed-End Funds	1974
Mutual Funds	1974
General	
Brokerage	
Limited Customer	Always
General Retail	1982
Securities Swapping	Always

*National banks; always for most state banks

**Explicitly Approved by Board of Governors of Federal Reserve System

Table 2

Securities Eligible for Underwriting and Dealing by Commercial Banks

1983

U.S. Treasury Department

General Obligations of States and Political Subdivision Thereof

Washington Metropolitan Area Transit Authority

Federal Farm Credit Banks

Federal Home Loan Banks

Obligations Insured by the U.S. Department of Housing and Urban Development

Federal National Mortgage Corporation

Government National Mortgage Corporation

Federal Financing Bank

Environmental Financing Authority

Student Loan Marketing Association

International Bank for Reconstruction and Development

Inter-American Development Bank

Asian Development Bank

African Development Bank

Revenue Obligations of States and Political Subdivisions and Agencies for Housing, University, or Dormitory Purposes

Tennessee Valley Authority

U.S. Postal Service

Federal Home Loan Mortgage Corporation

Footnotes

[1]Alan J. Daskin and Jeffrey C. Marquardt, "The Separation of Banking from Commerce and the Securities Business and the United Kingdom, West Germany, and Japan," Issues in Bank Regulation, Summer 1983, pp. 16-24.

[2]George G. Kaufman, Larry R. Mote, and Harvey Rosenblum, "The Future of Commercial Banks in the Financial Services Industry," Staff Memoranda, 83-5 (Federal Reserve Bank of Chicago), 1983.

[3]For histories of the development of investment and commercial banking, see Vincent P. Carosso, Investment Banking in America: A History (Cambridge, Massachusetts: Harvard University Press), 1970; Vincent P. Carosso, "Washington and Wall Street: The New Deal and Investment Bankers" Business History Review, Winter 1970, pp 425-45; Edwin J. Perkins, "The Divorce of Commercial and Investment Banking: A History," Banking Law Review, June 1971, pp 483-528; Fritz Redlich, "The Molding of American Banking: Men and Ideas (Vols. I and II) (New York: Hafner Publishing Co.), 1951; George G. Kaufman, "The Separation of Commercial and Investment Banking," in The U.S. Financial System, 2nd Ed. (Englewood Cliffs, N.J.; Prentice Hall), 1983; Arnold W. Sametz, Michael Keenan, Ernest Bloch, and Lawrence Goldberg, "Securities Activities of Commercial Banks: An Evaluation of Current Developments and Regulatory Issues," Journal of Comparative Corporate Law and Securities Regulation, November 1979, pp 155-193; and Harold R. Medina, Corrected Opinion: United States of American v. Morgan Stanley, et. al. (U.S. District Court, New York), February 4, 1954.

[4]The Banking At of 1933 also introduced federal deposit insurance. The Act combined Rep. Steagall's House bill establishing federal deposit insurance with Sen. Glass's bill separating commercial and investment banking.

[5]The sections of the Glass-Steagall Act of 1933, as amended, that deal with the securities activities of commercial banks are:

Section 16

> The business of dealing in securities and stock by the (national) association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issues of securities or stock: Provided (specifies securities qualified for the association's own investment account)...The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to (specifies securities exempted).
>
> (Section 5 extends these restrictions to Federal Reserve member banks.)

Footnotes

Section 20

No member bank shall be affiliated in any manner...with any corporation, association, business trust, or other similar organization engaged principally in the issue, floatation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

Section 21

It shall be unlawful...for any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject ot check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt or upon request of the depositor.

Section 32

No officer, director, or employee of any corporation or unincorporated asscciation, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

[6]Investment Co. Institute v Camp, 401 U.S. 617 (1971) U.S. Department of the Treasury, Public Policy Aspects of Bank Securities Activities: An Issues Paper, November 1975; Harvey L. Pitt, James H. Schropp and Julie L. Williams, "The Evolving Financial Services Industry: Statutory and Regulatory Framework and Current Issues in the Banking/Securities Arena: An Outline" (Working Paper, Washington D.C.), May 1983; and U.S. Congress, House, Committee on Government Operations, Confusion in the Legal Framework of the American Financial System and Service Industry: Hearings, 98th Congress, 1st Session, July 19-21, 1983.

[7]Comptroller of the Currency, "News Release," October 28, 1982 with accompanying documents.

Footnotes (cont'd)

[8]Federal Deposit Insurance Corporation "Proposed Rule to Govern Securities Activities of FDIC - Supervised Banks," May 16, 1983.

[9]Legal Division, Board of Governors of the Federal Reserve System Commercial Paper Activities of Commercial Banks: A Legal Analysis, June 28, 1979.

[10]Board of Governors of the Federal Reserve System, "Policy Statement on Sale of Third-Party Commercial Paper by State Member Banks," Federal Reserve Bulletin, June 1981, pp. 494-961, Pitt et al, op. cit.

[11]Board of Governors of the Federal Reserve System, "Commercial Bank Private Placement Activities" Staff Study, June 1977; Comptroller of the Currency, Federal Deposit Insurance Corporation, and Board of Governors of the Federal Reserve System, Commercial Bank Private Placement Activities, June 1, 1978.

[12]Board of Governors of the Federal Reserve System, Federal Reserve Bulletin (February 1972), pp. 149-151.

[13]Pitt et al, op. cit., pp. 43-47.

[14]Scott McMurray, "Morgan Guaranty Takes Aim at Wall Street," American Banker, July 8, 1983, pp 1, 3, 5, 6.

[15]Pitt et al, op. cit., pp. 156-158.

[16]A U.S. District Court judge ruled recently that brokerage subsidiaries of a bank are subject to the interstate branch prohibitions of the McFadden Act. This ruling is under appeal, it has important implications for the location of other subsidiaries of national banks. Jay Rosenstein, "Interstate Barriers Applied to Bank Brokerage," American Banker, November 4, 1983, pp. 1 and 14.

[17]"Proposed Rules," Federal Register (Washington, D.C.; Government Printing Office), November 15, 1983, pp. 51930-32; U.S. Congress, Senate, Committee on Banking, Housing and Urban Affairs, Reports on Banks Securities Activities of the Securities and Exchange Commission (Committee Print), 95th Cong. 1st Sess., August 1977; and Edward F. Greene, John C. Murphy, Jr., and W. Caffey Norman, 3d, "A Vote Against the SEC's Proposed Bank Rule," American Banker, December 13, 1983, pp. 4-9.

[18]"Ruling Allows Bank to Offer Investment Advisory Service," American Banker, September 14, 1983, pp. 4, 6, 14.

[19]Robert H. Smith, "Discount Brokerage - Alternative Delivery Systems," Conference on Bank Structure and Competition: Proceedings 1983, (Federal Reserve Bank of Chicago), forthcoming.

Footnotes (cont'd)

[20]FDIC, op cit

[21]For a discussion of nonbanks see Michael Bradfield "Statement Before the House Subcommittee on Commerce, Consumer and Monetary Affairs," July 21, 1983 and American Banker, August 19, 1983, pp 17-77. To reduce the incentive to create nonbanks, the Board of Governors expanded the definition of commercial lending in December 1983 to encompass almost all types of loans and investments including the purchase of CDs and bankers' acceptances and of deposits subject to withdrawal on demand to NOW accounts. Nonbanks organized before December 1982 were grandfathered and are not subject to these provisions. What adjustments have to be made by the nonbank organized since that date are not clear at this writing. (January 1984).

[22]Board of Governors of the Federal Reserve System, "Letter to C.T. Conover, Comptroller of the Currency (Concerning Pending Application of Dreyfus)", December 14, 1982; Comptroller of the Currency, "Decision of the Comptroller of the Currency on the Application to Charter J & W Seligman Trust Company N.A.," February 1, 1983 and Comptroller of the Currency, "Decision of the Comptroller of the Currency to Charter Dreyfus National Bank and Trust Company," February 4, 1983. The definitions of "principally" and "primarily" as well as the base activities to which these measures should be applied are in disputed among the regulatory agencies. The courts have held that "principally" requires greater involvement than "primarily." The Board of Governors has defined "primary" as representing 10 or more percent of gross income. The Board has also ruled that the management of a mutual fund by itself represents a principal engagement in the issuance of securities in violation of Section 20. The Comptroller, in contrast, considers a principal engagement only if the gross revenues from the issuance of securities represents at least 10 percent of the consolidated gross revenues of the overall organization, including subsidiaries if any.

The Board of Governors objected strenuously to the Seligman approval and threatened to fine the bank if it remained a member of the system. The Seligman Bank subsequently withdrew from membership by surrendering its national bank charter and was rechartered by New York State as a nonmember state bank.

[23]FDIC, op cit. The Federal Reserve apparently has accepted the FDIC interpretation, Paul Volcker, "Statement Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs," January 16, 1984, p. 7.

[24]This section draws heavily from Kaufman, op cit.

[25]For a review of the evidence pro and con see G.O. Bierwag, George G. Kaufman, and Paul H. Leonard, "Interest Rate Effects of Commercial Bank Underwriting of Municipal Revenue Bonds: Further Evidence," Journal of Banking and Finance, Forthcoming 1984.

Footnotes (cont'd)

[26]For additional evidence of commercial bank concentration, see Lance Girton, "Concentration of Financial Power" in exhibits to Written Statement of the Investment Company Institute Before the Senate Committee on Banking, Housing, and Urban Affairs on S. 1720, 97th Congress, First Session, October 22, 1981.

[27]For evidence of economies of scale and scope see George J. Benston et al, "Economies of Scale in Banking," Economic Review, (Federal Reserve Bank of Atlanta), November 1982.

[28]Similar well publicized alleged conflicts between underwriting and investment caused many states to separate investment banking and life insurance in the early 1900s. Carosso, op cit, pp. 110-127. See also Roy A. Schotland, "Conflicts of Interest Within the Financial Firm: Regulatory Implications," and Sam Peltzman, "Commentary" in Franklin R. Edwards, ed., Issues in Financial Regulation (McGraw Hill, 1979), pp. 123-161.

[29]U.S. Congress, Senate, Reports on Bank Securities Activities, pp. 97-99.